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SUBJECT: 2003 CANADIAN INVESTMENT CLIMATE STATEMENT

REFS: (A) STATE 128494 (B) OTTAWA 1543

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IN EB/IFD/OIA

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INVESTMENT CLIMATE STATEMENT FOR CANADA

Openness to Foreign Investment

General Attitude

2. With few exceptions, Canada offers foreign investors full national treatment within the context of a developed open market economy operating with democratic principles and institutions. Canada is, however, one of the few OECD countries that still has a formal investment review process, and foreign investment is prohibited or restricted in several sectors of the economy.

3. Canada's economic growth depends on foreign investment inflows. The stock of global foreign direct investment in Canada in 2002 was US\$223 billion, or 32.5% of Canadian GDP. In terms of revenue, four foreign-owned firms rank among the top ten corporations in Canada and the government estimates that foreign investors control about one-quarter of total Canadian non-financial corporate assets.

4. The United States and Canada agree on important foreign investment principles, including right of establishment and national treatment. The 1989 FTA recognized that a hospitable and secure investment climate would be indispensable if the two countries were to achieve the full benefits of reducing barriers to trade in goods and services. The agreement established a mutually beneficial framework of investment principles sensitive to the national interests of both countries, with the objective of assuring that investment flowed freely between the two countries and that investors were treated in a fair and equitable manner. The FTA provided higher review thresholds for US investment in Canada than for other foreign investors, but it did not exempt all American investment from review nor did it override specific foreign investment prohibitions, notably in the cultural area. In 1994 NAFTA incorporated the gains made in the FTA, expanded the coverage of the Investment Chapter to several new areas, and broadened the definition of investors with rights under the agreement. It also created the right to binding investor-state dispute settlement arbitration in specific situations.

Legal Framework: The Investment Canada Act

5. Since 1985, foreign investment policy in Canada has been guided by the Investment Canada Act (ICA) that replaced the more restrictive Foreign Investment Review Act. Industry Canada is the federal department that administers most investments, although the federal department of Canadian Heritage administers investments in Canada's "cultural industries" (broadcasting, publishing, audio-visual production or sound recording).

6. The ICA liberalized policy on foreign investment by recognizing that investment is central to economic growth and is the key to technological advancement. At the same time, it provided for review of large acquisitions in Canada by non-Canadians and imposed a requirement that these investments be of "net benefit" to Canada. For the vast majority of small acquisitions, as well as the establishment of new businesses, foreign investors need only notify the Canadian government of

their investment. The text of the ICA is available at the following web site: www.investcan.ic.gc.ca.

17. Investment Canada must be notified of any investment by a non-Canadian establishing a new Canadian business (regardless of size); acquiring direct control of any existing business that has assets of at least C\$5 million; or acquiring indirect control of any existing Canadian business with assets exceeding C\$50 million in value. However, the C\$5 million threshold was increased to C\$223 million in 2003 if the acquiring non-Canadian entity is a member of the World Trade Organization (WTO), and there is no review process for indirect acquisition of a Canadian business by any member of the WTO (with the exception of foreign acquisitions of any size in "cultural industries").

18. While the ICA provides the basic legal framework for foreign investment in Canada, investment in specific sectors may be covered by special legislation. For example, the Bank Act administers foreign investment in the financial sector that is within federal jurisdiction; investment in Canada's securities sector is covered under provincial legislation (see paragraph 7). The federal Broadcast Act governs foreign investment in radio and television broadcasting. Under provisions of the federal Telecommunications Act, foreign ownership of transmission facilities is limited to 20% direct ownership and 33% through a holding company, for an effective limit of 46.7% total foreign ownership.

19. Canada's federal system of government subjects investment to provincial as well as national jurisdiction. Provincial restrictions on foreign investment differ by province, but are largely confined to the purchase of land and to certain types of provincially regulated financial services. In addition, provincial government policies in the areas of labor relations and environmental protection can have an important impact on foreign investors.

Special Treatment for US Investment

10. United States foreign investment in Canada is subject to the Investment Canada Act, but the NAFTA Chapter 11 further defines the investment relationship between the two countries and provides national treatment. Regulation of Canadian investors in the United States and of US investors in Canada should result in treatment no different than that extended to domestic investors within each country. Both governments are free to regulate the ongoing operation of business enterprises in their respective jurisdictions under, for example, antitrust law, provided they do not discriminate. This principle is based on existing practice, detailed in the framework below.

11. Existing laws, policies and practices were grandfathered, except where specific changes were required. The practical effect was to freeze the various exceptions to national treatment provided in Canadian and US law, such as restrictions on foreign ownership in the communications and transportation industries. Both governments remain free to tax foreign-owned companies differently than domestic firms, provided this does not result in arbitrary or unjustifiable discrimination, and to exempt the sale of crown (government-owned) corporations from any national treatment obligations. Finally, the two governments retain some flexibility in the application of national treatment obligations. They need not extend identical treatment, as long as the treatment is "equivalent."

12. The NAFTA also deals more specifically with the financial services sector. Chapter 14 on financial services eliminates discriminatory asset and capital restrictions on US bank subsidiaries in Canada and exempts US firms and investors from the federal "10/25" rule, treating them like Canadian firms. The "10/25" rule prevents any single non-NAFTA, nonresident from acquiring more than 10% of the shares, and all such nonresidents in the aggregate from acquiring more than 25% of the shares of a federally regulated, Canadian-controlled financial institution. In 2001, the GOC raised the 10% rule to 20% for individual (but not corporate) shareholders.

13. Both the 10% and the 25% limitations were eliminated for American investors in federally chartered, non-bank financial institutions. Several provinces, however, including Ontario and Quebec, have similar "10/25" rules for provincially chartered trust and insurance companies which were not waived under the FTA.

14. The NAFTA commits both parties to expand the list of covered service sectors and includes a services agreement, a code of principles that establishes national treatment, right of establishment, right of commercial presence, and transparency for the service sectors enumerated in annexes to the NAFTA. Bilateral services trade is largely free of restrictions and the NAFTA ensures that new restrictions will not be applied. However, existing restrictions were

grandfathered.

15. The NAFTA grants US firms that operate from the United States national treatment for most Canadian federal procurement opportunities. However, inter-provincial trade barriers exist which often exclude US firms established in one Canadian province from bidding on another province's procurement opportunities. As a first step in the ongoing and difficult process of reducing trade barriers within Canada, the federal, provincial and territorial governments negotiated an Internal Trade Agreement that came into effect on July 1, 1995. The Agreement provides a framework for dealing with trade in ten specific sectors and establishes a formal process for resolving trade disputes (but does not apply to US firms).

16. Besides the areas described above, the NAFTA includes provisions that: enhance the ability of US investors to enforce their rights through international arbitration; prohibit a broader range of performance requirements, including forced technology transfer; and expand coverage of the Investment chapter to include portfolio and intangible investments as well as direct investment.

Investments In "Cultural Industries"

17. Canada defines "cultural industries" to include:

- the publication, distribution or sale of books, magazines, periodicals or newspapers, other than the sole activity of printing or typesetting;
- the production, distribution, sale or exhibition of film or video recordings, or audio or video music recordings;
- the publication, distribution or sale of music in print or machine-readable form;
- any radio, television and cable television broadcasting undertakings and any satellite programming and broadcast network services.

18. The Investment Canada Act requires that foreign investments in the book publishing and distribution sector be compatible with national cultural policies and be of net benefit to Canada. Authority for reviewing prospective foreign investments resides with the Minister for Canadian Heritage. Takeovers of Canadian-owned and controlled distribution businesses are not allowed. The establishment of new film distribution companies in Canada will only be allowed for importation and distribution of proprietary products. (In other words, the importer would have to own world rights or be a major investor). Indirect and direct takeovers of foreign distribution businesses operating in Canada are allowed only if the investor undertakes to reinvest a portion of its Canadian earnings.

19. All investments in newspapers and periodicals require Canadian government review. Authority for reviewing prospective foreign investments resides with the Minister for Canadian Heritage. Under terms of an agreement signed in June 1999, Canada significantly lowered its barriers to foreign magazines. Canada agreed to permit up to 51% foreign equity in a magazine enterprise, up from the previous 25%, and to increase this level to 100% by June 2000. As of June 2002, US magazines exported to Canada are permitted to carry 18% of total ad space with advertising aimed primarily at the Canadian market.

20. Canada also committed to provide non-discriminatory tax treatment under Section 19 of the Income Tax Act (eliminating the nationality requirement in June 2000), and Canadian advertisers may now place ads in any magazine regardless of the nationality of the publisher or place of production. Canadian advertisers, merchants and service providers may now claim a tax deduction for one-half of their advertising costs if they place ads in foreign magazines with zero to 79% Canadian editorial content. They may deduct full advertising costs if the magazine contains 80% or more original (specifically for the Canadian market) editorial content.

21. The Broadcasting Act sets out the broadcasting policy for Canada, the objectives of which include enriching and strengthening the cultural, political, social and economic fabric of Canada. The Canadian radio-television and telecommunications commission (CRTC) is charged with implementing the broadcasting policy. Under current CRTC policy, in cases where a Canadian service is licensed in a format competitive with that of an authorized non-Canadian service, the commission can drop the non-Canadian service if a new Canadian applicant requests it to do so. Licenses will not be granted or renewed to firms that do not have at least 80% Canadian control, represented both by shareholding and by representation on the board of directors.

Investments in the Financial Sector

122. Canada is open to foreign investment in the banking, insurance, and securities brokerage sectors, although, unlike the United States, Canada still has barriers to foreign access to retail banking. US firms are present in all three sectors, but play secondary roles, while Canadian banks have been much more aggressive in entering the US retail banking market because there are no barriers that limit access and because it offers more promising opportunities for investment than does the saturated Canadian market. Although American and other foreign banks have long been able to establish banking subsidiaries in Canada, no US banks have attempted to undertake retail banking operations in Canada. Several US financial institutions have established branches in Canada, chiefly targeting commercial lending, investment banking and niche markets such as credit card issuance.

Investments In Other Sectors

123. Commercial Aviation: Foreigners are limited to 25% ownership of Canadian air carriers.

124. Energy and Mining: Foreigners cannot be majority owners in uranium mines. However, there are no specific restrictions in other mining investment.

125. Telecommunications: Under provisions of Canada's Telecommunications Act, direct foreign ownership of Type I carriers (owners/operators of transmission facilities) are limited to 20%. Ownership and control rules are more flexible for holding companies that wish to invest in Canadian carriers. Under these rules, two-thirds of the holding company's equity must be owned and controlled by Canadians.

126. Fishing: Foreigners can own only 49% of companies that hold Canadian commercial fishing licenses.

127. Electric power is primarily under provincial jurisdiction in Canada, and is traditionally dominated by provincial government-owned firms. Several provinces have taken steps to restructure their electricity sectors on competitive principles. Alberta has achieved a degree of competition at both wholesale and retail levels.

128. In Ontario in recent years, the provincial monopoly utility was split up into generation, transmission and distribution components, and some competition was introduced at the retail level. However, in April 2002, a court ruling blocked a planned initial public offering of the provincial government-owned transmission grid operator, Hydro One. In November 2002, the Ontario government froze retail power rates at 4.3 cents/KWH for most customers until 2006. Since then, the government has struggled to increase generating capacity with little help from private investment.

129. Health Services: Hospitals in Canada are integral parts of a public health system administered by the provinces. Private hospitals would not be eligible to receive payments from provincial health insurance funds, and, therefore, would not be financially viable in most cases. However, the provincial health systems have always relied on private sector provision of many goods and services, and in recent years they have increasingly turned to private firms to supply diagnostic services and, particularly in Alberta, routine surgery. The governments of Canada and Alberta have disputed whether the latter is permissible under the Canada Health Act. To the extent that private firms are allowed to provide these services, U.S.-based companies are well positioned to compete.

130. Real estate: primary responsibility for property law rests with the provinces. Prince Edward Island, Saskatchewan, and Nova Scotia all limit real estate sales to out-of-province parties. There is no constitutional protection for property rights in Canada. Consequently, government authorities can expropriate property, but appropriate compensation must be paid. However, US individual investors have been troubled by changes in zoning or environmental regulations that affect use of their property (ref B).

131. Privatization: Each specific privatization (at the federal or provincial levels of government) is considered on a case-by-case basis, and there is no overall policy limitation on foreign ownership. As an example, the federal Department of Transport did not impose any limitations in the privatization of Canadian National Railway, whose current majority shareholders are now US citizens.

Investment Incentives

132. Both federal and provincial governments in Canada offer a wide array of investment incentives. (Municipalities are legally prohibited from offering tax incentives.) None of the federal incentives, however, are specifically aimed at promoting or discouraging foreign investment in Canada.

Rather, the incentives are designed to accomplish broader policy goals, such as investment in research and development, or promotion of regional economies. They are available to any qualified investor, Canadian or foreign, who agrees to use the funds for the stated purpose. Provincial incentives tend to be more investor-specific and are conditioned on applying the funds to an investment in the granting province. Provincial incentives may also be restricted to firms established in the province or that agree to establish a facility in the province.

133. Incentives for investment in cultural industries, at both the federal and provincial level, are generally available only to Canadian-controlled firms. Incentives may take the form of grants, loans, loan guarantees, venture capital, or tax credits. Incentive programs in Canada generally are not oriented toward the promotion of exports. Provincial incentive programs for film and television production in Canada are available to and used by foreign firms, so Canadian taxpayers have heavily subsidized U.S.-financed productions in recent years.

Protection of Property Rights

134. Private property rights are fully protected by Canada's legal system. Foreigners have full and fair access to Canada's legal system. Only the rights of governments to establish monopolies and to expropriate for public purposes limit property rights. Investors from NAFTA countries have mechanisms available to them for dispute resolution regarding property expropriation by the Government of Canada.

Performance Requirements/Incentives

135. Canada does not explicitly negotiate performance requirements with foreign investors. For investments subject to review, the Canadian Government can examine resource processing, domestic content, exports, and technology development or transfer. A special duty remission scheme exists for the automotive sector that makes certain benefits contingent on trade performance. NAFTA Article 1106 prohibits the United States or Canada from imposing export or domestic content performance requirements. Government officials at both the federal and provincial levels expect investors who receive investment incentives to use them for the agreed purpose, but no enforcement mechanism exists.

Regulatory System: Laws and Procedures

136. Canada's regulatory system is similar to that of the United States in terms of its transparency and broad array of institutions involved. Proposed regulatory laws are subject to parliamentary debate and public hearings, and regulations are issued in draft form for public comment prior to implementation. While federal and/or provincial licenses or permits may be needed to engage in economic activities, this kind of regulation is generally for statistical or tax compliance reasons. The Bureau of Competition Policy and the Competition Tribunal, a quasi-judicial body, enforce Canada's antitrust legislation.

Labor

137. The Federal government and Provincial/territorial governments share jurisdiction for labor regulation and standards. For example, employees in the railroad, airline and banking sectors are covered under the federally administered "Canada Labor Code" while employees in most other sectors would come under provincial labor codes. As the laws vary somewhat from one jurisdiction to another, it is advisable to contact a federal or provincial labor office for specifics such as minimum wage and benefit requirements. From the 1960s to the 1990s, Canada's relatively generous federal employment insurance and other social programs, combined with its high rate of unionization compared to the United States, made the Canadian labor force relatively inflexible and kept unemployment rates relatively high. In recent years, however, these differences have narrowed, due particularly to the restructuring of the employment insurance program.

138. Due in part to the value of the Canadian dollar relative to the US dollar, Canadian wage and benefit levels for most non-executive job categories are somewhat lower than levels paid in the United States. In 2001, the proportion of union membership among those in paid employment was 32%, which reflects a 19% union membership rate in the private sector and a 72% union membership rate in the public sector. This union participation rate is about twice that seen in the United States.

Expropriation and Compensation

139. Canadian federal and provincial laws recognize both the right of the government to expropriate private property for a public purpose, and the obligation to pay compensation. The federal government has not nationalized any foreign firm since the nationalization of Axis property during World War II. Both the federal and provincial governments have also assumed control of private firms -- usually financially distressed ones -- after reaching agreement with the former owners. (See ref B for more detail on expropriation claims.)

Dispute Settlement -----

140. Canada is a member of the New York Convention of 1958 on the Recognition and Enforcement of Foreign Arbitral Awards. The Canadian government has made a decision in principle to become a member of the International Center for the Settlement of Investment Disputes (ICSID). However, since the legal enforcement mechanism for ICSID would be the provincial court system, the federal government must also obtain agreement from the provinces that they will enforce ICSID decisions. It is unlikely that this will happen in the foreseeable future.

141. Canada accepts binding arbitration of investment disputes to which it is a party only when it has specifically agreed to do so through a bilateral or multilateral agreement, such as a Foreign Investment Protection Agreement. The provisions of Chapter 11 of the NAFTA guide the resolution of investment disputes between the United States and Canada. The NAFTA encourages parties to settle disputes through consultation or negotiation. It also establishes special arbitration procedures for investment disputes separate from the NAFTA's general dispute settlement provisions. Under the NAFTA, a narrow range of disputes (those dealing with government monopolies and expropriation) between an investor from a NAFTA country and a NAFTA government may be settled, at the investor's option, by binding international arbitration. An investor who seeks binding arbitration in a dispute with a NAFTA party gives up his right to seek redress through the court system of the NAFTA party, except for proceedings seeking non-monetary damages.

Political Violence -----

142. Although rare, political violence does occur in Canada. Serbian demonstrators protesting the air war in Kosovo vandalized the United States Consulate General in Toronto in 1999. In addition, there have been some violent incidents related to trade and environmental disputes.

Bilateral Investment Agreements and Tax Treaties -----

143. While the terms of the FTA and the NAFTA guide investment relations between the United States and Canada, Canada has also negotiated international investment agreements with non-NAFTA parties. These agreements, known as Foreign Investment Protection Agreements (FIPAs), are bilateral treaties that promote and protect foreign investment through a system of legally binding rights and obligations based on the same principles found in the NAFTA. Within Canada's overall foreign investment strategy, FIPAs complement the NAFTA. Canada has negotiated FIPAs with countries in Central Europe, Latin America, Africa and Asia, and has over 100 international tax treaties in force. Please refer to the following Internet web site for more information: www.fin.gc.ca

Capital Outflow Policy -----

144. The Canadian dollar is fully convertible. The Canadian government provides some incentives for Canadian investment in developing countries through Canadian International Development Agency (CIDA) programs. Canada's official export credit agency, the Export Development Corporation (EDC), provides OPIC-like insurance coverage for Canadian foreign investment.

Tables: Foreign Direct Investment Data and
2002 Mergers & Acquisition Activity

Line 1 = C\$ Millions
Line 2 = US\$ Millions

| Canadian | Foreign | Direct | Invest | Abroad | | |
|----------|------------------|----------------|----------------|--------------|----------------|------------------|
| | U.S. | U.K. | Other E.U. | Japan | All Other | Total |
| 1998 | 133267 89862 | 24956 16828 | 29149 19655 | 3268 2204 | 70269 47382 | 260909 175931 |
| 1999 | 151775 102141 | 25686 17287 | 28384 19102 | 3853 2593 | 81032 54535 | 290730 195661 |

| | | | | | | |
|---------------------------|------------------|----------------|----------------|--------------|-----------------|------------------|
| 2000 | 177839 148522 | 35164 23676 | 39162 26368 | 5664 3814 | 95321 64180 | 353150 237776 |
| 2001 | 188791 121921 | 39742 25665 | 41607 26870 | 7033 4542 | 112486 72643 | 389660 251642 |
| 2002 | 201792 128501 | 45241 28809 | 54612 34777 | 9203 5860 | 120971 77034 | 431819 274982 |
| Foreign | Direct | Invest | In | Canada | | |
| Year | U.S. | U.K. | Other E.U. | Japan | All Other | Total |
| 1998 | 146893 99050 | 17042 11491 | 31126 20988 | 8393 5659 | 15935 10745 | 219389 147934 |
| 1999 | 176045 118478 | 15279 10283 | 36341 24457 | 8270 5566 | 16629 11191 | 252563 169975 |
| 2000 | 191870 129186 | 23184 15610 | 63240 42579 | 8126 5471 | 21171 14254 | 307591 207101 |
| 2001 | 214227 138348 | 25204 16277 | 65954 42593 | 7909 5108 | 20342 13137 | 333635 215461 |
| 2002 | 224330 142853 | 26273 16731 | 67700 43111 | 8600 5476 | 22485 14318 | 349388 222490 |
| Source: Statistics Canada | | | | | | |

TOP FIVE LARGEST MERGERS AND ACQUISITIONS ANNOUNCED AND COMPLETED IN CANADA IN 2002:(VALUES IN US\$ AND C\$ BILLIONS)

| VALUE | NAME | ROLE |
|---------------------|---|--|
| US\$5.9 (C\$9.2) | Alberta Energy Co. Ltd. PanCanadian Energy Corp. | Target Target |
| US\$4.1 (C\$6.4) | Manulife Financial Corp. Canada Life Financial Corp. | Acquirer Target |
| US\$4.1 (C\$6.3) | BCE Inc. Bell Canada SBC Communications Inc. | Acquirer Target Vendor |
| US\$2.0 (C\$3.2) | Petro-Canada Oil & Gas Properties (Int'l) British Petroleum Co. PLC Veba Oil & Gas GmbH | Acquirer Target Vendor Vendor |
| US\$1.9 (C3.0) | ONTARIO TEACHERS PENSION PLAN BOARD Kholberg Kravis Roberts & Co. Telephone Director Business (Can.) BCE Inc. | ACQUIRER Acquirer Target Vendor |

Source: Crosbie & Company Investment Bank

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